

Accounting for Certificates of Participation

An issuance of certificates of participation (COPs) is a mechanism for providing capital to school districts and county offices to purchase equipment, finance construction projects, or refinance existing leases. This financing technique provides long-term financing through a lease with an option to purchase or a conditional sales agreement. The major disadvantage of a COP is that there is no repayment source connected to its issuance.

The following points are important to understanding how certificates of participation are accounted for in conformity with generally accepted accounting principles (GAAP):

1. The financing of certificates of participation typically involves the following parties:

Lessee (Issuer)—A school district or county office of education.

Lessor—A nonprofit corporation, joint powers authority, leasing company, bank or other entity that holds title to the equipment during the lease period.

Trustee—A commercial bank or trust company that receives the proceeds, collects the lease payments on behalf of the lessor, and/or repays the notes. The trustee is required to adhere to the standards in the trust agreement and maintain the trust fund accounts. The trust fund accounts show all disbursements made against the certificates of participation's proceeds as well as any interest earned.

Underwriter—A municipal securities dealer who commits to the purchase of the certificates and remarkets them to investors. The underwriter will charge a fee, known as the underwriter's discount, to assume the underwriting risk of the COPs.

2. At the time the proceeds of the COPs are deposited with the trustee, the money legally belongs to the local educational agency (LEA). Therefore, at this time, the LEA must record the proceeds in its books. (See entry 1 on page 606-4.)
3. The proceeds of the COPs should be reported in the fund that will be used to acquire or construct the assets. This will typically be the General Fund or a Capital Projects Fund.

School districts may identify developer fees as the repayment source for COPs. If this is the case, the LEA will record the proceeds of the COPs in the Capital Facilities Fund.

4. The LEA must review the section of the COPs' documents titled "Sources and Uses of Funds" to determine the opening entry needed on the LEA's books to account for the COPs. The following sources or uses of funds will typically be found:

Accrued Interest—The amount of interest accrued on COPs from the issue date until closing. The underwriter pays this amount to the trustee at closing, and the money is held by the trustee in the lease payment account as a credit toward the first scheduled lease payment. For this reason the accrued interest is recorded as interest payable. (See entry 1 on page 606-4.)

Capitalized or Funded Interest—The amount of interest on a COP that will accrue from the COP's issue date to the date the project or property being financed is projected to be completed. California law precludes issuers from making lease payments unless they have constructive use or occupancy of the property being financed. The funded interest is a component of the COP's proceeds and is used to pay the investors their semiannual interest payments during the construction period. As a matter of practice, funded interest normally extends two to three months beyond the projected completion date to cover unforeseen delays.

Reserve Account (Reserve for Debt Service)—Underwriters typically require a debt service reserve funded by the proceeds of the COP. The reserve is held by the trustee to pay investors in the event of the issuer's default or in the case of late payment. If neither of these situations occurs, the reserve account is used to make the final lease payment. Because the amount of the COP's proceeds which represents the Reserve for Debt Service is legally restricted, this amount must be shown as a reservation of fund balance at year-end. (See entry 8 on page 606-5.)

Underwriter's Discount—The fee a municipal underwriter charges to assume the underwriting risk of the COP. The underwriter's fees will typically be deducted from the proceeds before the proceeds are deposited with the trustee.

5. The trustee will maintain the proceeds in various trust accounts. The trustee will provide information to the LEA on all activity in the trust accounts. The LEA must account for all such activity in its books in the funds and accounts available for use by the LEA.
6. *It is not necessary to make the lease payments for COPs out of a separate debt service fund.* The examples on pages 606-4 through 606-5 show the accounting for COPs in conformity with generally accepted accounting principles.

Assume, for example, that on August 1, 1992, a school district issues certificates of participation for the purchase of 193 school buses from ABC Bus Company. XYZ Bank is designated as trustee of the certificates and is assigned the right to enforce amounts payable by the district under the agreement.

Estimated Sources and Uses of Proceeds

Sources	
Certificate Proceeds	\$18,200,000
Accrued Interest	<u>100,000</u>
Total Sources	\$18,300,000
Uses	
Cost of Equipment	\$14,950,000
Capitalized Interest	500,000
Reserve for Debt Service	2,700,000
Underwriter's Discount	<u>150,000</u>
Total Uses	\$18,300,000

Assume that the Reserve for Debt Service of \$2,700,000 was invested and estimated to earn interest of \$110,000 through January 31, 1993, and \$92,000 from February 1 through June 30, 1993.

The lease payment schedule is as follows:

Lease payment dates	Principal component	Interest component	Total payment
February 1, 1993		\$ 500,000	\$ 500,000
August 1, 1993	\$ 3,200,000	500,000	3,700,000
February 1, 1994		400,000	400,000
August 1, 1994	3,300,000	400,000	3,700,000
February 1, 1995		300,000	300,000
August 1, 1995	3,500,000	300,000	3,800,000
February 1, 1996		200,000	200,000
August 1, 1996	3,800,000	200,000	4,000,000
February 1, 1997		100,000	100,000
August 1, 1997	<u>4,400,000</u>	<u>100,000</u>	<u>4,500,000</u>
Total	\$18,200,000	\$ 3,000,000	\$ 21,200,000

Key Entries for Certificates of Participation in Conformity with GAAP—Equipment Purchase—SACS Entries

August 1, 1992 Proceeds from the sale of the certificates of participation (COPs) are deposited with the trustee (in the name of the LEA). <ul style="list-style-type: none">• The terms of the COPs require a debt service reserve of \$2,700,000.• All interest earned on the debt service reserve is available for debt repayment.	1. General Fund DR Cash with trustee 01-0000-0-0000-0000-9135-000 \$18,150,000 DR Underwriter's discount 01-0000-0-0000-9100-5800-000 150,000 CR Proceeds from certificates of participation 01-0000-0-0000-0000-8971-0000 \$18,200,000 CR Interest payable 01-0000-0-0000-0000-9500-0000 100,000 To record the receipt of the proceeds from the sale of the COPs to be used for the purchase of equipment
September 1, 1992 Equipment is purchased.	2. General Fund DR Equipment 01-0000-0-0000-3600-6400-000 \$14,950,000 CR Cash in county treasury 01-0000-0-0000-0000-9110-000 \$14,950,000 To record the purchase of 193 buses acquired through the issuance of COPs
November 1, 1992 Reimbursement is received from trustee.	3. General Fund DR Cash 01-0000-0-0000-0000-9110-000 \$15,000,000 CR Cash with trustees 01-0000-0-0000-0000-9135-000 \$15,000,000 To record the reimbursement received from the trustee
February 1, 1993 Interest is received on the investments of the \$2,700,000 debt service reserve.	4. General Fund DR Cash with trustees 01-0000-0-0000-0000-9135-000 \$ 110,000 CR Interest revenue 01-0000-0-0000-0000-8660-000 \$ 110,000 To record the interest earned on the debt service reserve
The first lease payment is made, which represents interest only (See the lease payment schedule on page 606-3).	5. General Fund DR Debt service - interest 01-0000-0-0000-9100-7438-000 \$ 400,000 DR Interest payable 01-0000-0-0000-0000-9500-000 100,000 CR Cash with trustee 01-0000-0-0000-0000-9135-000 \$ 500,000 To record the first payment on the COPs

Key Entries for Certificates of Participation in Conformity with GAAP—Equipment Purchase—SACS Entries

<p>June 30, 1993</p> <p>Interest of \$92,000 is earned on the debt service reserve.</p>	<p>6. General Fund</p> <p>DR Interest receivable 01-0000-0-0000-0000-9200-000 \$ 92,000</p> <p>CR Interest revenue 01-0000-0-0000-0000-8660-000 \$ 92,000</p> <p>To accrue interest earned on the investment of the debt service reserve</p>
<p>June 30, 1993</p> <p>The books of the LEA are closed.</p>	<p>7. General Fund</p> <p>DR Proceeds—COPs 01-0000-0-0000-0000-8971-000 \$18,200,000</p> <p>DR Interest revenue 01-0000-0-0000-0000-8660-000 202,000</p> <p>CR Debt service - interest 01-0000-0-0000-9100-7438-000 \$ 400,000</p> <p>CR Underwriter's discount 01-0000-0-0000-9100-5800-000 150,000</p> <p>CR Equipment 01-0000-0-0000-3600-6400-000 14,950,000</p> <p>CR Unappropriated fund balance 01-0000-0-0000-0000-9790-000 2,902,000</p> <p>To close revenues, expenditures, and other financing sources and uses</p> <p>8. General Fund</p> <p>DR Unappropriated fund balance 01-0000-0-0000-0000-9790-000 \$ 2,700,000</p> <p>CR Reserve for debt service 01-0000-0-0000-0000-9719-000 \$ 2,700,000</p> <p>To reserve that portion of fund balance that represents the required debt service reserve</p>
<p>July 5, 1993</p> <p>The interest earned on the debt service reserve is received.</p>	<p>9. General Fund</p> <p>DR Cash with trustee 01-0000-0-0000-0000-9135-000 \$ 92,000</p> <p>CR Interest receivable 01-0000-0-0000-0000-9200-000 \$ 92,000</p> <p>To record the receipt of the interest on the debt service reserve</p>
<p>August 1, 1993</p> <p>The second lease payment is made.</p>	<p>10. General Fund</p> <p>DR Debt service - interest 01-0000-0-0000-9100-7438-000 \$ 500,000</p> <p>DR Other Debt Service - Principal 01-0000-0-0000-9100-7439-000 \$3,200,000</p> <p>CR Cash in county treasury 01-0000-0-0000-0000-9110-000 \$3,498,000</p> <p>CR Cash with trustee 01-0000-0-0000-0000-9135-000 202,000</p> <p>To record the second lease payment on the COPs</p>

